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No. 63

In the Supreme Court of the United States

OCTOBER TERM, 1939

V. L. LETULLE, PETITIONER

v.

**FRANK SCOFIELD, UNITED STATES COLLECTOR OF
INTERNAL REVENUE FOR THE FIRST DISTRICT OF
TEXAS**

**ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT
COURT OF APPEALS FOR THE FIFTH CIRCUIT**

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

No written opinion was filed by the trial court. The opinion of the Circuit Court of Appeals (R. 211-215) is reported at 103 F. (2d) 20.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 3, 1939 (R. 216). A petition for rehearing was filed, and was denied April 27, 1939 (R. 217). Petition for a writ of certiorari was

filed May 22, 1939, and was granted October 9, 1939 (R. 220). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether, in the circumstances of this case, the exemption from taxation applicable to corporate reorganizations applies to a transfer of property which was owned, at the time of the agreement upon which the claimed reorganization was based, not by the transferor corporation, but by the taxpayer, its sole stockholder, and which was conveyed to the transferor corporation, if at all, only in order to be included in the properties conveyed to the transferee.

2. Whether the acquisition by one corporation of all the properties of another is a reorganization when the consideration consists entirely of cash and bonds, with the result that the transferor has only the interest of a creditor.

STATUTE INVOLVED

The pertinent provisions of the statute involved are printed in the Appendix, *infra*, pp. 26-28.

STATEMENT

In 1931 the taxpayer was the sole stockholder of the Gulf Coast Irrigation Company (R. 47-48), which owned certain pumping plants, machinery, canals and other irrigation property (R. 55). The

taxpayer individually owned certain other lands and irrigation properties (R. 61, 215):

Pursuant to a contract dated November 4, 1931 (R. 55-64), the Gulf Coast Irrigation Company agreed to convey to the Gulf Coast Water Company all of the irrigation properties it then owned, as well as "certain other lands and irrigation properties" which it "will be the owner of" prior to the time of conveyance (R. 55). The other lands and irrigation properties referred to in the contract were those then owned by the taxpayer individually. The transfer was to be made for a consideration of \$50,000 in cash and \$750,000 in secured bonds of the Water Company (R. 56-57).

The record discloses the method by which the taxpayer endeavored to include his individual property in the so-called reorganization scheme.

On November 7, 1931, after the agreement with the Water Company had been executed, a special meeting of the stockholders of the Irrigation Company approved the proposed reorganization (R. 69-70). The minutes of this meeting state (R. 70) that the taxpayer, "desiring also to reorganize his interest in the properties", had consented to be a party to the reorganization. To this end, an increase of the capital stock of the Irrigation Company from 1,000 shares to 2,660 shares was authorized (R. 69-70).

The minutes of a special meeting of the board of directors of the Irrigation Company, held on the

same day, indicate that the taxpayer had subscribed for the new stock and had agreed to pay the sum of \$166,000 "in property to be conveyed" to the company (R. 74-75). Thereafter, on November 18, 1931, the Irrigation Company (through the taxpayer as its president) and the taxpayer individually, joined in a deed transferring the properties to the Water Company (R. 81-83). The record fails to disclose the transfer of the taxpayer's individual property to the Irrigation Company before the latter purported to transfer it to the Water Company.

Additional taxes for the fiscal period during which the transaction occurred were assessed against the petitioner as transferee and against the petitioner and his wife individually, on the ground that taxable gains resulted from the disposition of the property (R. 47-49, 51-53). The tax was paid and in due time suits were commenced to recover the amounts so paid, asserting that the transaction was a nontaxable corporate reorganization (R. 1-13, 14-30). The Government denied generally the allegations of the petitions (R. 13-14, 30). The cases were consolidated (R. 31):

At the trial the taxpayer testified that he had made a prior contract for the sale of these irrigation properties to the Continental Service Company (R. 134). Thereafter, during the trial, the Government filed a motion for continuance (R. 31-44) for the purpose of developing the true situa-

tion. The motion alleged that the Government would be able to show that the taxpayer individually had already sold his properties before he agreed to transfer them to the Gulf Coast Irrigation Company for 1,660 shares of its stock, and that he should have accounted for the profit on the sale in his individual income-tax return. The Government's motion further asserted that the contract of November 4, 1931, upon which the taxpayer was relying to show a reorganization, was "a sham and a subterfuge to put into another form a completed transaction in order to avoid the tax that was due on such completed transaction" (R. 40).

The trial judge overruled the Government's motion for continuance (R. 44) and ordered judgment in favor of the taxpayer for the full amount (R. 45-46).

The Government again asserted that the property had been disposed of by the taxpayer before the purported reorganization, in its motion for a new trial (R. 153-159). This motion was denied by the trial judge (R. 200). At that time the Government had been able to obtain a copy of the original contract for the sale of the properties dated November 5, 1930, and executed by the taxpayer individually and as president of the Gulf Coast Irrigation Company (R. 162-168). Extracts of corporate minutes had also been obtained (R. 155-158) showing that the contract had been kept alive, that down payments had been made thereon and that

the transferee of the rights thereunder was proceeding to close the deal. It was further asserted in the motion for a new trial (R. 159) that evidence then available would show that there had been an outright sale of the assets in question before November 4, 1931, and that the contract dated November 4, 1931, "was entered into between the parties merely for the purpose of calling the transaction a reorganization for the sole and exclusive purpose of attempting to evade taxes."

In the assignment of errors (R. 202-206) exceptions were specifically taken to the refusal of the trial court to grant the Government's motion for continuance (R. 205) and its motion for a new trial (R. 206), and it was asserted that had an opportunity been given to prove the averments made in the motions it would have been demonstrated that the taxpayer had disposed of the property individually owned by him by an outright sale under the prior contract instead of through the purported reorganization.

The Circuit Court of Appeals did not regard the denial of the Government's motions as error but instead, on the basis of the facts established by the evidence in the record, reversed the judgment of the trial court in so far as it had applied the reorganization provisions to the properties individually owned by the taxpayer at the time the contract was entered into (R. 215).

SUMMARY OF ARGUMENT

I

The court below did not depart from the issue presented by the record. It merely held that the *reason* advanced by the Collector for holding the transaction outside the reorganization provision of the statute was without merit, but held that, for a different reason, that part of the property previously belonging to the taxpayer was not property of the corporation which could be transferred without the recognition of gain.

The Circuit Courts of Appeals are not limited to a consideration of the *reasons* advanced in support of a contention. The authorities do not support the taxpayer's argument that the court below had no authority to apply to the facts any legal reasoning not urged by the parties.

The court below correctly held that the properties of a corporation which may be transferred in a tax-free reorganization cannot include properties transferred to the corporation merely for the purpose of re-transfer to the purchasing corporation. Any temporary holding of the taxpayer's property by the Irrigation Company under the facts of this case was transitory and without real substance.

The decision below rests on the conclusion that the reorganization provisions of the statute were intended to cover transfers of only such assets as could be deemed corporate properties in a sub-

stantial sense, and the court did not err in its remand by failing to allow the introduction of additional evidence.

II

The decision below also should be affirmed on the further ground that the transfer of properties to the Water Company did not in fact and in law constitute a reorganization within the meaning of the statute. As interpreted by the decisions of this Court, the acquisition by one corporation of all of the property of another corporation is not alone sufficient to constitute a reorganization. In addition, the transferring corporation, or its stockholders, must acquire a direct, definite, and material interest of a proprietary nature in the affairs of the purchasing corporation. The interest represented by the bonds of the purchasing corporation is not such an interest in the affairs of that corporation as is contemplated by the statute.

ARGUMENT

I

THE CIRCUIT COURT OF APPEALS CORRECTLY HELD THAT INsofar AS PETITIONER'S PERSONALLY OWNED PROPERTIES WERE INCLUDED IN THE TRANSACTION, IT WAS NOT A REORGANIZATION WITHIN THE MEANING OF THE STATUTE

(A) THE CIRCUIT COURT OF APPEALS DID NOT DEPART FROM THE ISSUE

The issue presented to the Circuit Court of Appeals was whether or not a tax-free reorganization

occurred when the Irrigation Company transferred certain properties to the Water Company in consideration of cash and bonds of the Water Company. The Circuit Court of Appeals held that the transaction was a reorganization insofar as it affected the property of the Irrigation Company, but that it was not a reorganization insofar as it affected the taxpayer's individual property which was sought to be included in the corporate transaction.

We submit that this decision was within the issue presented. Confining itself to the question of reorganization, the Circuit Court of Appeals merely held that the *reason* asserted by the Government in support of the contention that the transaction was wholly outside of the reorganization provision was without merit, but that for another reason the transaction was partly outside of such provision.

It has never been the law that the Circuit Courts of Appeals are limited to a consideration of the *reasons* advanced in support of a contention. So long as they keep within the issue, parties are entitled to support their contentions in the Circuit Courts of Appeals with new arguments, new authorities, and new reasoning not presented in the trial court. Similarly, the court of its own *motion* is authorized to apply v authorities and new reasoning and decide the question as justice may require.

In this litigation the Government originally contended that this transaction was not a reorganiza-

tion; petitioner, on the other hand, contended that the transaction was a reorganization. The Circuit Court of Appeals was not required to agree entirely with either contention. It was free to hold that the transaction was partly a reorganization and partly a sale, and that is precisely the effect of its decision. Because the Government did not suggest the possibility that the transaction might be so regarded is no reason for denying it the benefit of the judgment of the Circuit Court of Appeals.

Petitioner's contention that the Circuit Court of Appeals had no authority to apply to the facts any legal reasoning not urged upon the court by the parties is clearly not supported by the authorities. In *General Utilities Co. v. Helvering*, 296 U. S. 200, the question presented to the Circuit Court of Appeals was whether a corporation realized taxable income by satisfying a dividend liability in stock which cost it a lesser amount. However, the court undertook to decide that the corporation realized taxable income upon the sale of the dividend stock by the stockholders. Not only was this a new and different issue, but in deciding it the Circuit Court of Appeals drew an inference of fact directly in conflict with the stipulation of the parties and the findings, to wit, that the stockholders in making the sale acted as agents of the corporation.

Unlike that case, the Circuit Court of Appeals here has confined itself to the issue presented and made no inconsistent inferences of fact. The rec-

ord clearly shows that the property transferred in the purported reorganization included assets which at the time of the contract of sale were not the property of the corporation; that the price was agreed upon by the vendee on the basis of the property then owned by the corporation and "certain other lands and irrigation properties" of which it would become owner¹; and that petitioner's individual property was sought to be included in the corporate reorganization. As a matter of law, the reorganization provisions of the statute do not extend to transfers of property by an individual to a corporation except where the individual is in control of the corporation immediately after the transfer. Section 112 (b) (5). We submit that the Circuit Court of Appeals was clearly authorized to decide that the transaction was a reorganization only insofar as it affected the transfer of the corporate property.

In a similar situation dealing with a reorganization question, the Circuit Court of Appeals for the Second Circuit in *Helvering v. Gregory*, 69 F. (2d) 809, disagreed with the reasoning of the Commissioner, but nevertheless sustained his position upon a theory developed by the court. In that case the Government had contended that the new corporation should be disregarded and the transfer to and through it treated as inoperative. The Circuit

¹ The record does not show of what those other properties consisted. (Pet. 5.)

Court of Appeals held that the corporation should not be disregarded but nevertheless held that the transaction was not a reorganization. The court said (p. 811):

We do not indeed agree fully with the way in which the Commissioner treated the transaction; we cannot treat as inoperative the transfer of the Monitor shares by the United Mortgage Corporation, the issue by the Averill Corporation of its own shares to the taxpayer, and her acquisition of the Monitor shares by winding up that company. The Averill Corporation had a juristic personality, whatever the purpose of its organization; the transfer passed title to the Monitor shares and the taxpayer became a shareholder in the transferee. All these steps were real, and their only defect was that they were not what the statute means by a "reorganization," because the transactions were no part of the conduct of the business of either or both companies; so viewed they were a sham, though all the proceedings had their usual effect.

This Court affirmed the decision (293 U. S. 465), and evidently regarded the action of the Circuit Court of Appeals as a proper exercise of its judicial function.

Petitioner's contention that the burden was upon the Government to plead and prove as an affirmative defense that petitioner had resorted to a scheme or device to avoid taxes is apparently

grounded upon a misconception of the decision of the Circuit Court of Appeals. That court did not decide that petitioner must forfeit the benefit of the reorganization provisions because of fraud. The device to which the court referred was the device of including individual property in a corporate reorganization. That does not involve any element of fraud and petitioner's contention that the Circuit Court of Appeals has decided a question which should have been pleaded and proved is wholly lacking in force.

(B) THE TERM "PROPERTIES" OF A CORPORATION WITHIN THE MEANING OF THE REORGANIZATION PROVISIONS DOES NOT INCLUDE ASSETS TRANSFERRED TO THE CORPORATION MERELY FOR THE PURPOSE OF RE-TRANSFER

Pursuant to a contract dated November 4, 1931, the Irrigation Company agreed to convey all of the irrigation properties it then owned as well as "certain other lands and irrigation properties" which it "will be the owner of" prior to the actual transfer (R. 55). The "other lands and irrigation properties" thus referred to were then owned by the petitioner individually. The record fails to disclose the transfer of petitioner's individual property to the Irrigation Company before the transfer to the purchaser. It does show that on November 18, 1931, the Irrigation Company (through the petitioner as president) and the petitioner individually joined in a deed transferring the properties to the purchaser (R. 81-83). Since petitioner was the

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plaintiff and had the burden of proof, he is not entitled to any assumptions in his favor. Nevertheless, the Circuit Court of Appeals did assume that petitioner conveyed his individual property to the Irrigation Company. The court said (R. 215):

On Nov. 7, 1931, a meeting of the stockholders of the Irrigation Company was held at which the capital stock of the Company was increased from \$100,000 to \$266,000. The entire increase was thereupon subscribed for by LeTulle, and paid for in property conveyed to the Company at a price of \$166,000. The stockholders' meeting then ratified the contract of Nov. 4, 1931, and authorized the conveyance of all its properties and business accordingly. The evidence thus plainly shows that a large part of the property conveyed under the contract of Nov. 4, 1931, was not at that date owned by the Irrigation Company but by LeTulle, and that he conveyed it to his company by the device above stated in order to transfer it to the purchaser along with the property of the Irrigation Company. The statute makes no provision for the "reorganization" of an individual. The "plan of reorganization" which the Irrigation Company and LeTulle signed with the Water Company operated as a reorganization of the Irrigation Company, but the property of LeTulle which was embraced in it was simply sold by him. Using the Irrigation Company as a conduit for passing the title does

not alter the substance of the matter. Only so much of the consideration as represents the price of the properties and business of the Irrigation Company is entitled to be protected from taxation as arising from a reorganization.

Thus the decision of the court below rests upon an interpretation of the applicable reorganization provision of the statute as dealing exclusively with corporate "properties" in a substantial sense. The reorganization provisions deal with transfers of property by an individual to a corporation, but such a transaction is not within the statute unless the individual owns at least 80 per centum of the stock of the transferee immediately after the transfer. Section 112 (b) (5) and 112 (j). However, under another provision of the statute a reorganization occurs upon "the acquisition by one corporation of * * * substantially all the properties of another corporation." (Section 112 (i) (1) (A).) Accordingly the question is whether petitioner's individually owned properties are "properties" of a corporation within the meaning of Section 112 (i) (1) (A). Assuming that they were actually conveyed to the Irrigation Company, that company was committed to reconvey them to the Water Company, and we think they were not properties of the Irrigation Company in the substantial sense contemplated by the statute. Accordingly we submit that the court below correctly

decided that the reorganization provisions of the statute are not applicable to such assets.

This Court has interpreted the reorganization provisions as disregarding a temporary holding of stock on the ground that it "was transitory and without real substance; it was part of a plan which contemplated the immediate transfer of the stock." *Helvering v. Bashford*, 302 U. S. 454, 458. See also *Bassick v. Commissioner*, 85 F. (2d) 8, 10 (C. C. A. 2d), certiorari denied, 299 U. S. 592; rehearing denied, 299 U. S. 623. We submit that the same principle is applicable here and that petitioner's individually owned assets had no relation to any business conducted by the corporation. Cf. *Western Industries Co. v. Helvering*, 82 F. (2d) 461, 464 (App. D. C.). Therefore, they could not properly be treated as its "properties" for the purpose of applying the reorganization provisions.

(C) THERE IS NO OCCASION TO REMAND FOR THE INTRODUCTION
OF ADDITIONAL EVIDENCE

Petitioner's contention that the Circuit Court of Appeals should in any event have authorized the introduction of additional evidence upon the remand is based upon a misconception. He assumes (Br. 23) that the Circuit Court of Appeals attempted to bring this case within the decision of this Court in *Gregory v. Helvering*, 293 U. S. 465, and he contends (Br. 18-22) that if given an opportunity he could establish that the transfer of his individually owned property to the Irrigation

Company and the retransfer by the Irrigation Company to the purchaser served a business purpose which would take the case out of the principle of the *Gregory* decision.

However, the Circuit Court of Appeals did not cite the *Gregory* case and, as heretofore stated, we submit that the decision below rests upon the conviction that the reorganization statute was intended to cover a transfer of only such assets as could be deemed corporate properties in a substantial sense. If this is a true construction of the reorganization statute, it is obvious that it would be futile to remand the case for further findings. Cf. *General Utilities Co. v. Helvering*, 296 U. S. 200, 207. Moreover, petitioner's argument does not indicate that he would be able to prove that the transaction was in furtherance of any corporate purpose of the Irrigation Company. His argument merely tends to show that the purpose was to accomplish one or another of several possible personal advantages to petitioner himself as a distributee of the proceeds of the transaction.

If we are mistaken in our understanding of the opinion of the Circuit Court of Appeals, and if, properly construed, it holds that as a matter of law the sale of the LeTulle properties must be regarded as a direct sale by LeTulle to the Water Company, then the case apparently rests upon the principle that the Revenue Acts implicitly require that a business purpose be served by the transac-

tion. *Helvering v. Gregory, supra.* If the opinion of the Circuit Court of Appeals be so construed, we concede that the petitioner should have the opportunity to present additional evidence upon that point if he can, although nothing yet suggested indicates that any business purpose was served by the form which the transaction took. Since petitioner does not suggest that the *Gregory* decision is otherwise inapplicable, he is not entitled to any further relief.

II

THE DECISION BELOW SHOULD BE AFFIRMED ON THE GROUND THAT THE TRANSACTION INVOLVED DID NOT CONSTITUTE A REORGANIZATION.

In any event, we urge that the decision of the Circuit Court of Appeals, reversing in part the judgment of the District Court, be affirmed on the ground that the property transferred to the Gulf Coast Water Company was not disposed of in a reorganization as defined by Section 112 (i) of the Revenue Act of 1928, c. 852, 45 Stat. 791, and that the bonds of the Water Company received by the taxpayer in liquidation of the Gulf Coast Irrigation Company did not constitute securities of a corporation a party to a reorganization within the meaning of Section 112 (b) (3) of that Act.

Section 112 (i) of the 1928 Act, *supra*, provides:

- (1) The term "reorganization" means
- (A) a merger or consolidation (including

the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization; or (D) a mere change in identity, form, or place of organization, however effected.

In this case the Gulf Coast Water Company acquired substantially all of the property of the Gulf Coast Irrigation Company for \$50,000 cash and \$750,000 face value of its own bonds, payable serially over a period of twelve years, and secured by a mortgage on the properties so transferred.

The language of the above definition does not in terms exclude the sale of stock or assets of a corporation for cash, or for cash and bonds or short-term notes, but it is now established by the decisions of this Court that the definition contained in the statute is a restricted one (*Groman v. Commissioner*, 302 U. S. 82, 86), and that the selling corporation or its stockholders must acquire a direct, definite, and material interest in the affairs of the purchasing corporation in order to comply with the exempting provisions of the statute. *Pinellas Ice Co. v. Commissioner*, 287 U. S. 462; *Nelson Co. v.*

Helvering, 296 U. S. 374, 377; *Helvering v. Minnesota Tea Co.*, 296 U. S. 378, 385; *Groman v. Commissioner*, 302 U. S. 82, 89; *Helvering v. Bashford*, 302 U. S. 454.

Accordingly, the fact that the acquisition of the assets falls within the literal terms of the section does not mean that such transaction is a statutory reorganization. See particularly *Worcester Salt Co. v. Commissioner*, 75 F. (2d) 251, 252 (C. C. A. 2d), and cases there cited. There must be "some assured participation in the properties of the transferee." *Cortland Specialty Co. v. Commissioner*, 60 F. (2d) 937, 940 (C. C. A. 2d), certiorari denied, 288 U. S. 599. In that case, approved by this Court in *Pinellas Ice Co. v. Commissioner*, 287 U. S. 462, 470, the court said (p. 940):

Each transaction presupposed a continuance of interest on the part of the transferor in the properties transferred. * * * Judge Groner's opinion in *Corbett v. Burnett*, 60 App. D. C. 202, 50 F. (2d) 492, is in accord. In defining "reorganization," section 203 of the Revenue Act gives the widest room for all kinds of changes in corporate structure, but does not abandon the primary requisite that there must be some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption.

And in *Helvering v. Minnesota Tea Co.*, *supra*, the Court, after explaining this principle as laid

down in the *Pinellas Ice Co.* case, *supra*, and after quoting therefrom at length, said (p. 385):

And we now add that this interest must be definite and material; it must represent a substantial part of the value of the thing transferred. This much is necessary in order that the result accomplished may genuinely partake of the nature of merger or consolidation. [Italics supplied.]

In *Pinellas Ice Co. v. Commissioner*, *supra*, and in *Cortland Specialty Co. v. Commissioner*, *supra*, it clearly was indicated that in order to meet the requirements of the statute there must be some "real semblance to a merger or consolidation" and "some assured participation in the properties of the transferee."

Worcester Salt Co. v. Commissioner, *supra*, involved facts substantially similar to the facts in the instant case. There the taxpayer purchased all of the stock of the Kerr-Remington Salt Company on June 1, 1928. Thereafter, the latter transferred to the taxpayer all of its assets, subject to its liabilities, in exchange for \$680,000 bonds of the taxpayer. The Circuit Court of Appeals for the Second Circuit pointed out (*id.*, p. 252) that by this transfer the taxpayer acquired the properties of the Kerr-Remington Salt Company and the transaction fell within the definition of "reorganization" contained in Section 112 (i) (1) (A) of the 1928 Act, *supra*. It added, however (P. 252):

But the fact that the transaction is included within the literal terms of this section does

not mean that such a transaction is a statutory reorganization. * * * This transaction was a purchase of assets, not a reorganization. * * * The transaction in the instant case in no sense can be deemed to "partake of the nature of a merger or consolidation." The Kerr-Remington Salt Company had no interest in the petitioner because, like the notes in the *Pinellas Case*, bonds are merely an evidence of indebtedness and gave the Kerr-Remington Salt Company no interest in the petitioner itself. Continuity of interest is a requisite.

But compare *Lilienthal v. Commissioner*, 80 F. (2d) 411 (C. C. A. 9th), and *Commissioner v. Freund*, 98 F. (2d) 201 (C. C. A. 3d).

The court below recognized that the decision of this Court in *Helvering v. Watts*, 296 U. S. 387, is not controlling here because that case arose under a different clause of the statute, and the question concerning the bonds was merely whether they were "securities." In the *Watts* case all of the stock of one corporation was transferred to another in exchange for stock of the latter, and, in addition, for mortgage bonds guaranteed by the latter. The transaction was held to be a reorganization because a part of the consideration was stock, and therefore the decision merely announced that the presence of the bonds would not defeat the reorganization. The question here is whether a transfer for a large amount of cash becomes a reorganization merely by substituting bonds for approximately 90 per

ntum of the purchase price, and the *Watts* case does not answer that question.

The question whether a reorganization occurred under Section 112 (i) (1) is a different question from whether bonds are securities under Section 112 (b) (3). In every reorganization case it is first necessary to determine whether there has been a reorganization within the meaning of the definition of Section 112 (i) (1). A determination that this definition is satisfied leads to the second question, whether the operative provisions which grant the exemption, e. g., Section 112 (b) (3), are applicable. In the *Watts* case it was only necessary to consider the stock in answering the first question, while here the answer to that question turns upon whether the bonds represent a sufficient continuity of interest to satisfy the accepted test. We submit that bonds alone do not satisfy that requirement because they are merely evidences of indebtedness. This contention is squarely supported by the decision in *Averill v. Commissioner*, 101 F. (2d) 44 (C. C. A. 1st), where the court said (p. 647) that the *Watts* case does not decide that the ownership of bonds without stock constitutes such a continuing interest as is essential to a statutory reorganization.

In rejecting the collector's contention the court now appears to rest its decision (R. 213-214) upon the decision of this Court in *Nelson Co. v. Belvering*, *supra*, where the selling corporation re-

ceived preferred stock in the buying corporation for its assets. That case is not controlling, however, because preferred stock clearly represents an entirely different interest in the assets of the issuing corporation from that represented by bonds, whether secured or unsecured. The latter merely evidences an indebtedness of the issuing corporation. Bonds confer no greater proprietary interest in the property of the issuing corporation than the short-term notes involved in *Pinellas Ice Co. v. Commissioner, supra*.

This Court has never passed upon the precise question involved in this case. We submit, however, that upon authority of the decisions discussed above, it is evident that bonds, secured or unsecured, do not represent such an interest in the property transferred therefor as to constitute a reorganization within the meaning of the statute.

A somewhat similar question was before the Circuit Court of Appeals for the Second Circuit in *Commissioner v. Tyng*, 106 F. (2d) 55, in which a different conclusion was reached. A petition for a writ of certiorari is being prepared in that case and will be filed shortly.

CONCLUSION

The decision of the court below is correct. It is supported by the facts and the law and should be affirmed. In any event, the decision should be affirmed for the reason that the taxpayer is liable for

the tax upon the full amount of gain realized during the taxable year.

Respectfully submitted.

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NOVEMBER 1939.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat: 791:

SEC. 111. DETERMINATION OF AMOUNT OF GAIN OR LOSS.

(a) *Computation of gain or loss.*—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in section 113, and the loss shall be the excess of such basis over the amount realized.

* * * *

(c) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(d) *Recognition of gain or loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

* * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges solely in kind.*—

* * * *

(3) *Stock for stock on reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) *Same—Gain of corporation.*—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * * * *

(d) *Same—gain of corporation.*—If an exchange would be within the provisions of subsection (b) (4) of this section if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—

(1) If the corporation receiving such other property or money distributes it

in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, * * *

(g) *Distribution of stock on reorganization.*—If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized.

(i) *Definition of reorganization.*—As used in this section and sections 113 and 115—

(1) The term “reorganization” means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

